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TREASURY FOR INTERNATIONAL AFFAIRS - CPLANTIER

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TAGS: EFIN ECON TU
SUBJECT: TURKEY'S MUCH-IMPROVED DEBT SITUATION

This cable was coordinated with Congen Istanbul.

1.(SBU) Summary: 2005 capped four years of steadily improving public sector debt ratios in Turkey. Net debt to GDP is expected to be less than 60% of GDP at yearend 2005, compared to over 90% in 2001. For the first time since the 2001 crisis, the numerator of this ratio, net public sector debt, began to decline in the second half of 2005. Good luck in the form of favorable global market conditions combined with strong policies to allow the Turkish government to stabilize its mostly short-term domestic debt situation, greatly reducing - but not eliminating -- its vulnerability to external market disruptions and reducing their severity if disruptions do occur. End Summary.

Precarious post-crisis debt structure

¶2. (SBU) In the aftermath of the 2001 financial crisis, the Turkish state was saddled with a large debt burden that amounted to 90 percent of GDP. More problematic than the size of the debt was its structure: most of the debt was short-term, traded domestic debt, leaving the GOT dependent on its ability to constantly roll over its debt in local financial markets. Unlike many emerging markets, Turkey's domestic debt has represented a much bigger vulnerability than its foreign borrowings, which have been much longer-term and have accounted for less than a third of total debt (currently 26%). From 2001 to 2004, with high rates of inflation keeping interest rates in double digits, Turkey had to borrow more and more merely to service existing debt. Consequently, the stock of public sector debt has grown in dollar or lira terms every year since the crisis despite strong growth, large primary surpluses, declining inflation, and a consequent decline of interest rates.

Dramatic Improvement in Debt Indicators

¶3. (SBU) 2005, a watershed year in a number of respects for the Turkish economy, was also a turning point in Turkey's debt situation. Net public sector debt as a ratio to GDP has declined over the past four years despite the growth in the dollar and lira value of the stock of public sector debt. From a ratio of over 90% of GDP in 2001, final 2005 data are expected to put net public debt to GDP at under 60%.

¶4. (SBU) There are other signs of a stabilized debt profile. Total debt service leveled off at about YTL 188 billion

($142 billion) in both 2004 and 2005. Moreover, Turkish Treasury's generally conservative projections show that in 2006 there will be a decline in debt service to YTL 168.4 billion. State Planning Organization Deputy Under Secretary Birol Aydemir says that in the second halfof 2005 the numerator of the net public debt o GDP ratio, i.e. net public debt, had begun to decline in nominal terms for the first time since the crisis. Aydemir also emphasized the importance of the fact that 2006 projections show no net public sector borrowing requirement.

¶5. (SBU) Treasury now finds itself in the strongest position vis--vis the markets since before the crisis. Its planned rollover ratio (the ratio of newly-issued, traded domestic debt to redemptions) for 2006 is only 77%, far below 2005's 89% or 2004's 98%.

¶6. (SBU) Treasury's newfound strength enabled it to announce it would use 2006 to continue to lengthen the maturity of its new issuances. (Some of the maturity-lengthening comes at the expense of greater interest rate risk: Treasury's longer-dated paper increasingly carries a floating -- rather than a fixed -- interest rate.) Treasury had already taken steps to lengthen maturities: from January 2004 to December 2005, the average maturity on traded domestic debt lengthened from 12.8 months to 19.6 months. On January 25, Treasury issued $1.04 billion of 5-year lira-denominated fixed rate debt for example, a type of instrument it had only started to be able to place in small quantities in the domestic market in 2004.

¶7. (SBU) Treasury has also been gradually reducing its vulnerability to exchange rate risk. Following the crisis, when lira interest rates were prohibitively high, Treasury lowered its overall interest bill by borrowing both

externally and domestically in lower interest rate foreign exchange-denominated or -indexed instruments. The trade-off for the lower borrowing costs, of course, was increased exposure to a sharp fall in the exchange rate. This risk remains: as Turkey's current account deficit has grown as a share of GDP, a sharp fall in the exchange rate is a distinct possibility, and one in which the lira value of Treasury's foreign exchange-denominated debt would spike. Treasury's improving debt situation, however, has allowed it to address this risk by lowering the share of foreign exchange-denominated or -indexed debt from two thirds of total debt in 2003 to 37.6% in December 2005. The 2006 borrowing program calls for a further reduction in the share of foreign exchange debt.

Good Luck and Good Policies

¶8. (SBU) Good luck and good policies have worked together to achieve the much-improved debt situation. First, the independent Central Bank succeeded in bringing down inflation through tight monetary policy. CPI inflation, which was 68.5% in 2001 and 29.7% in 2002, had dropped to 9.4% by 2004 and reached 7.7% in 2005. Lower inflation brought down nominal interest rates, allowing Turkish Treasury to realize large savings on its interest payments. Total state interest payments peaked in 2003 at YTL 54.7 billion, declining in 2004 to YTL 50.3 billion and YTL 45.5 billion in 2005, despite the increasing stock of debt.

¶9. (SBU) Investors gradually demanded less of a risk premium as they saw the discipline and success of both monetary and fiscal policies. According to Treasury calculations, as of end-November 2005, real interest rates had fallen to 7.5% versus 9.5% in December 2004.

¶10. (SBU) The IMF and European Union "anchors" have both played an important role in giving investors confidence to

take on Turkish sovereign risk. Particularly in the first post-crisis years, the IMF program was critical for investor confidence. More recently, the GOT's reaching agreement on a new Stand-by Arrangement with the Fund in the spring of 2005, and the December 17, 2004 and October 3, 2005 decisions by the EU have played a major role in reassuring markets.

¶11. (SBU) Turkey has also been very lucky about global market conditions. The Federal Reserve and other major central banks have pursued mostly accommodative policies in recent years. This has left yield-hungry global investors keen to take advantage of emerging markets' high yields. Within this broader phenomenon, Turkey's high but falling yields and "EU convergence play" situation has proven irresistible to portfolio investors who have piled in to Turkish securities, including government debt. The surge of portfolio investment has caused the lira to strengthen, exacerbating the current account deficit problem but reducing the lira value of foreign exchange-denominated debt.

¶12. (SBU) In 2005 and 2006, a series of high-profile privatization deals also helped Turkish Treasury's cash position. The proceeds of these sales are being used to pay off debt or build Treasury's cash reserves, further reducing Treasury's borrowing need. Treasury's borrowing program data show total privatization receipts of YTL 3.6 billion in 2005 and project YTL 7.0 billion in 2006, much of which consists of installment payments on deals agreed to in 2005.

Comment and Conclusion

¶13. (SBU) Though Turkey still has a large share of short-term debt, its debt ratios have greatly improved. Despite continued vulnerabilities in the overall Turkish macroeconomic situation, (such as the large current account deficit) there has been a precipitous decline in the probability of a scenario in which the Turkish state has trouble rolling over its debt. The lower risk has been reflected in recent upgrades by rating agencies, but even more so by the ever-declining risk premia on Turkish debt. Turkish Eurobonds, for example, are now trading at spreads normally associated with sovereign credits that are rated higher than Turkey's current BB- rating. If the GOT

perseveres on its structural reform agenda, both with the IMF and the EU, most analysts expect further upgrades in the course of 2006.

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